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Secretary-General
UN Conference on Trade and Development

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To the International Monetary and Financial Committee
and the Development Committee

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Chairman Carstens,
Chairman Padoa-Schioppa,
Excellencies,
Ladies and Gentlemen:

In my last address to the Development Committee and to the International Monetary and Financial Committee, I discussed the financial turmoil that had erupted in August 2007. At that point, I highlighted the presence of substantial underlying vulnerabilities in the global economic system but I was hopeful that the consequences of the crisis of the sub-prime mortgage market in the United States of America would be short-lived and that financial normalcy would return by the end of the year. However, the instability originating with the collapse of the sub-prime mortgage market has proven more profound and persistent than many had expected. It has spread well beyond those involved in sub-prime lending itself, turning into a widespread squeeze in liquidity and credit. We are now approaching the tenth month of the crisis without really seeing the light at the end of the tunnel.

The risk posed to developing countries from the current economic and financial turmoil is likely to be among the issues under consideration at UNCTAD's Twelfth Conference, which will convene in Accra, Ghana, from 20-25 April 2008. The Conference takes place amid much uncertainty about world economic prospects, with continued instability on financial markets and slowing growth in the industrialized world. The International Monetary Fund and World Bank have reduced their estimates of global growth for this year. In its *World Economic Survey and Prospects* report in January the United Nations warned that the world economy could be hit much harder if unrest in the major currency markets adds to the irritation triggered by the sub-prime mortgage crisis. The danger that this is going to happen any time in 2008 has not diminished.

According to our estimates, world output is expected to grow by 2 ½ per cent in 2008, a full percentage point less than in 2007 and around one percentage point less than most early estimates of global growth in 2008 had expected. Growth in the advanced economies will be below 1.5 per cent, with the United States expected to grow by less than one per cent. We expect growth in the developing world at 6 per cent to remain quite robust. The slowdown elsewhere should only shave off about one percentage points of the 2007 growth performance. A number of relatively large developing countries have achieved quite stable dynamics of domestic demand, but in many others growth continues to depend on the evolution of international commodity prices and the way that the increased revenues from primary commodity exports are being used.

Nevertheless, the downside risks have increased substantially. If, for example, the liquidity crisis were to spillover to the market for emerging market debt, developing countries could face a sudden increase in their financing costs. Given that developing countries as a group have a much stronger external position than in the past, the consequences of such an increase in financing costs would not be as harsh as those of the financial crises of the second half of the 1990s, but they could still lead to severe problems, especially in those developing countries which are running large and unsustainable current account deficits.

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The sub-prime mortgage market meltdown has exposed the fragility of today's financial sector. Instead of reducing risk, the complex financial instruments developed in the recent years have ended up spreading the impact of risky investments across continents, institutions and markets. In a document released in late September 2007,[1] UNCTAD suggested that there must be something fundamentally wrong with a financial system that cannot survive for more than three or four years without facing a damaging or at least unsettling crisis. UNCTAD was then a rather lonely voice, highlighting the risks of securitization and asking for more financial regulation and supervision. Today, this view appears to be more widely shared.

In the absence of such regulation, there is a risk that policy-makers will have to continue to bail out parts of the financial sector, thus passing the cost of crises to the taxpayer and society at large. Until recently, it was thought that moral hazard associated with the explicit or implicit presence of a lender of last resort was a problem only for deposit-taking commercial banks. However, recent actions of the Unites States' Federal Reserve have shown that investment banks can also be deemed to be "too big to fail" and that their liabilities are protected by an implicit insurance. Given the risks for financial stability, the US Federal Reserve was right in providing such insurance and preventing the bankruptcy of a large investment bank. But insurance should not come for free. If the government decides that investment banks need to be bailed out because they can lead to a systemic crisis, they should be treated like deposit-taking banks and be subject to tighter prudential regulation. The traditional argument against increased regulation, based on the idea that market discipline is enough to monitor banks' behavior, is no longer valid, if it ever was. The recent crisis has shown once again that market discipline is ineffective in preventing recurrent episodes of "irrational exuberance" and that the market mechanism cannot cope with massive drops of financial asset prices.

A new regulatory structure should take into account the potential cyclical effects of regulation itself. This includes not introducing tighter regulatory standards in the midst of a liquidity crisis. In fact, it would be optimal to have a regulatory structure with built-in automatic stabilizers. An interesting proposal along this line is to have cyclically adjusted capital standards. More than 30 years ago, Charles Kindleberger showed that financial crises follow booms driven by excessive optimism. As a consequence, the probability of a crisis can be reduced with policies that limit lending during booms. An interesting proposal along these lines is to relate bank prudential

[1] See UNCTAD (2007) *Recent Developments on global financial markets* (TD/B/54/CRP.2) Geneva United Nations Conference on Trade and Development, 28 September

capital requirements to the growth rate of total bank lending. With such a policy, capital requirements would become tighter during lending booms (i.e., periods of excessive liquidity) and laxer during liquidity crises.

The current crisis does not only have implications for the prudential regulation of financial institutions, but it should also influence the way in which we think about macroeconomic policies, especially monetary and exchange rate policies. The last 25 years have been characterized by limited macroeconomic volatility and low inflation in the industrial world, a phenomenon that has been dubbed as "the Great Moderation." This decrease in volatility led several central banks in both developed and developing countries to focus on a single policy instrument in conducting monetary policy. Within this framework, the central bank concentrates on the behaviour of the short-term interest rate and allows other variables, such as the exchange rate, to be completely determined by market forces.

This policy approach does not recognize that countries and economies are interlinked and that the exchange rate plays a key role in these linkages. The recent financial turbulence and the unsustainable position of a number of countries with large current account deficits in all parts of the world underscores the need for more and better international economic coordination. In several issues of its *Trade and Development Report*, UNCTAD called for better international coordination of macroeconomic policies. The current policy framework generates temporarily profitable but finally destabilizing opportunities for speculative activities, often called "carry trade". The ongoing crisis could further trigger the unwinding of such carry trade positions and exacerbate the risk of a global meltdown. While the world's major central banks have shown good coordination in providing liquidity to banks and to other financial institutions affected by the crisis, their monetary policies are more divergent than ever. The US Federal Reserve has been very aggressive in cutting policy rates and thus trying to limit the real effects of the financial crisis, but other central banks, especially the European Central Bank, have been more restrained. Central banks of countries directly affected by the unwinding of carry trade have even sharply increased their interest rates. These divergent polices may invite new speculation in currencies instead of calming down the system.

Such divergent approaches in macroeconomic policies might be justified in the presence of a serious inflationary risk. However, despite the recent hike in oil and other commodity prices and the fact that in many countries headline inflation is slightly above inflation targets, the risk of accelerating inflation is still rather low. Core inflation and its most important component, unit labor costs, are not following the trajectory of the oil price explosions of the 1970s and the first signs that the prices of commodities are stabilizing or even declining are appearing on the horizon. While the commodity price rise has brought changes in relative prices, the overall inflation outlook is benign. In the absence of negative second round effects of the commodity price rise on nominal wages, policymakers have sufficient room to stimulate demand. On the other hand, the likelihood of a sharp and prolonged downturn of the world economy is high because concerted action that could prevent this downturn is not currently in the range of vision. While policymakers stand ready to fight smaller fires induced by increased uncertainty in financial markets, they have not yet found a way to tackle successfully challenges of a global nature.

The United States have actually reduced the risk of a hard landing for the global economy by adopting aggressive expansionary macroeconomic policies. However, the sharp fall in the value of the dollar which in part results from these policies has a restrictive impact on all those countries that export to the US. Here, for example, international coordination should be improved. Countries with large current account surpluses and sluggish internal growth could complement the efforts of the United States by stimulating their own domestic demand and thereby their import growth, especially in the Euro zone and Japan. China, with high growth and fast rising domestic consumption, is in a very different position.

In principle, the same is true for developing and transition economies with large surpluses associated with high commodity prices. If these countries have limited capacity to immediately absorb their higher revenues, they could play an active role in promoting financial stability by smoothly and effectively recycling the capital account equivalent of their large surpluses. Some large European and US banks have relied on sovereign wealth funds to rebuild their capital base. This shows how important this recycling may be. In light of this, it is difficult to understand that sovereign wealth funds are welcomed by financial institutions in advanced economies but that, at the same time, they have been the object of open criticism and scrutiny on the part of the governments of several advanced economies. Such a negative attitude is usually justified by the fear that sovereign wealth funds may be partly motivated by political objectives and pose security threats. However, all available evidence suggests that the objectives of these funds are not different from those of private investors. Moreover, on the positive side, sovereign wealth funds provide a much more stable investor base than most private equity funds that are known for their "short-termism". In light of the need to recycle capital surpluses as effectively as possible, the role of Sovereign Wealth Funds in the crises and in general should generally be welcome.

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An obvious conclusion from the recent experience in the world economy is that it is high time to revisit the question of the role of public policy and government intervention in influencing market outcomes, at both the national and international level. One of the reasons for the current fragile state of the world economy is shortcomings in the system of global economic governance, in particular a lack of coherence between the international trading system, which is covered by set of internationally agreed rules and regulations, albeit imperfect, and the international monetary and financial system, which is not. The apparent failure of foreign exchange markets to bring about changes in exchange rates that reflect shifts in international competitiveness and in current account balances suggests the need for reviewing the institutional framework of the international exchange-rate system.

The recent exchange-rate misalignments and financial turbulence have also shown, once again, the need for financial sector reforms at both the national and international levels, including the design of more appropriate international rules and regulations and more effective international financial institutions. In particular, it is necessary to strengthen the supervision of financial markets and increase the transparency of structured financial products. Instability in international currency and financial markets is the result of unregulated international financial activities and cannot be remedied by national policies alone. Moreover, in order to achieve greater coherence in global economic governance it will be necessary to strengthen the institutional framework to address the potential impact of volatile capital flows more adequately and effectively. Emerging markets and developing countries would be in a better position to face this challenge if they could have more confidence in receiving timely multilateral financial support, for which a new IMF liquidity instrument is required.

A reform of the international economic governance system would be incomplete without better institutionalized policy coordination and surveillance over the macroeconomic policies of all countries, especially those whose policies have an impact of the world economy as a whole. Given their increasing importance for the global economy, the participation of developing countries in these processes is essential, and should be expanded beyond the reforms that have already been achieved. Reforming the voting structure of these institutions is necessary to guarantee their long-term viability and relevance, especially for institutions like the International Monetary Fund, which are reducing their lending and increasing their surveillance activities. I welcome the IMF Board's resolution that would lead to an increase in the representation of several developing economies and congratulate Managing Director Strauss-Kahn for his success in securing such a resolution. However, this should only be the first step of a continued increase in the representation of developing countries.

Thank you very much.